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Navigating the treacherous political economy of structural reform

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NAVIGATING THE TREACHEROUS POLITICAL ECONOMY OF STRUCTURAL REFORM

DAVIDE FURCERI, JONATHAN D. OSTRY, CHRIS PAPAGEORGIOU AND DENNIS P. QUINN

We examine the economic and electoral effects of liberalisation measures using newly-constructed databases on structural economic reforms and the outcome of democratic elections since the 1970s. The data shows a remarkable slowdown in the pace of liberalisation in both advanced and emerging market and developing countries since the 1990s. A debate has emerged about the causes of this slowdown, including the possibility that reforms do not deliver the economic benefits that advocates, including the multilateral financial institutions, trumpeted. Some have pointed to the fact that the current and previous United States administrations have abandoned neoliberal policies in favour of more government intervention in the economy, and the effect has been globally contagious.

Our empirical analysis suggests that the growth dividend from liberalisation is economically and statistically significant, but it emerges only slowly over time. Because of this delay, liberalising reforms are costly to democratic incumbents when they are implemented close to elections. Reforms may generate immediate concentrated losses, which elicit an electoral backlash, especially when the aggregate gains are only visible several years after the reform's implementation. The electoral penalty is also sensitive to overall business-cycle conditions, being much larger when an economy is in recession. Electoral effects also differ depending on the type of reform. Notably, financial reforms generate more perceptible growth-equity trade-offs than real-economy reforms, especially when implemented during weak economic conditions.

The political economy of reform is treacherous. To avoid adverse electoral effects, timing reform early in the electoral term and when business-cycle conditions are favourable is critical. So too is avoiding reforms that generate large distributional costs in the face of small aggregate gains (an adverse growth-equity trade-off). Focusing on these considerations is critical to reinvigorate support for structural reform.

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1 Introduction

Those who advise governments on improving medium- to long-term economic performance draw on a voluminous literature about the benefits to be had from productivity-enhancing structural reforms. The rationale is that by encouraging greater sway of market forces in an economy, incentives are sharpened, investments in physical and human capital increase, and efficiency-enhancing technologies are adopted. Fiscal and monetary policies are useful tools to regulate the macroeconomy in the short term, but structural reforms are what deliver durable increases in average living standards over time.

There is of course no sharp line between the short and medium term, but with the massive fiscal stimulus in response to two once-in-a-century global economic crises already in this century – the 2007-2008 global financial crisis and the COVID-19 pandemic – fiscal policy is constrained. The constraints are even more daunting in a forward-looking sense, given the need to support the green and demographic transitions. The growth dividend that structural policies offer is all the more valuable given the scarcity of fiscal space¹.

It is worrisome, therefore, that according to data presented in Ostry *et al* (2009) and Alesina *et al* (2020), there has been a marked slowing in structural liberalisation measures in both advanced and emerging and developing economies since the 1990s². Of course, given the significant progress made in removing impediments to trade in goods and finance over the previous decades, some slowdown is perhaps unsurprising. But the reform agenda remains substantial worldwide, and even more so among emerging and developing economies, given their considerable reform gaps with frontier liberalisers.

One school of thought is that enthusiasm for structural reform was always more a reflection of ideology than based robustly on the evidence. The International Monetary Fund, for example, has been accused of pulling its punches on structural reform, failing to admonish countries in its flagship publications on the need to restore reform's flagging momentum³. A plausible interpretation of the IMF's hesitancy could be a belated recognition that reforms simply don't deliver as advertised. An alternative interpretation is that the IMF has come to recognise that reforms may be unpopular with electorates and proselytising in favour of reform might actually undercut the ability of politicians to implement liberalisation. But why would a curative (liberalisation) that is so clearly beneficial for treating a disease (weak productivity and growth) be so unpopular? As Rogoff (1990) famously argued, well-informed voters would seem likely to reward political leaders whose policies signalled economic competence.

¹ Jonathan Ostry, 'We Need a Better Blueprint for Structural Reforms', *Financial Times*, 3 March 2024, <https://www.ft.com/content/edd8714b-aafe-4d8a-85a7-2c37278cbabb>.

² The backlash against neoliberalism is also moving many countries away from free-market oriented supply-side policies, as noted in the article cited in footnote 1.

³ *The Economist*, 'Are politicians brave enough for daredevil economics?', 8 November 2023, <https://www.economist.com/finance-and-economics/2023/11/08/are-politicians-brave-enough-for-daredevil-economics>.

2 The economic dividend from reform

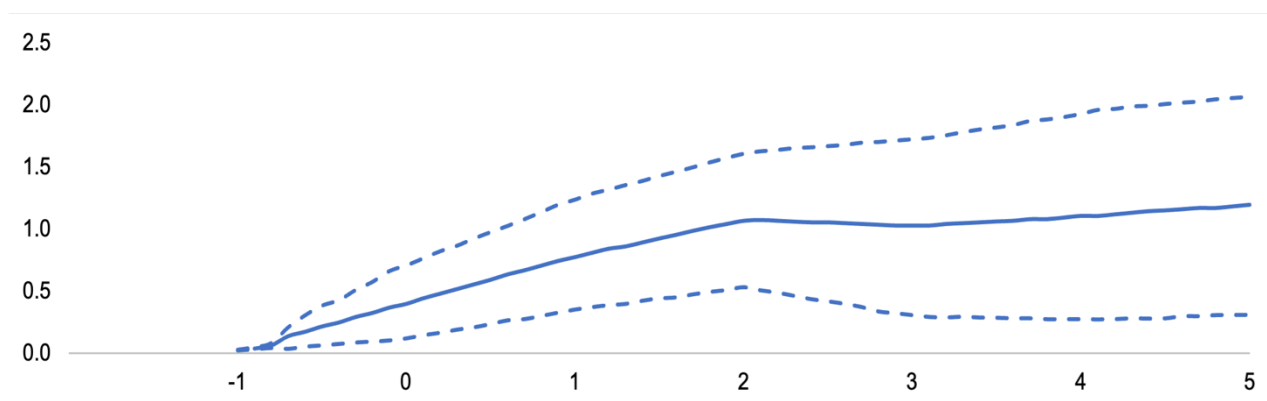
In Alesina *et al* (2020), we used a local projection (LP) framework (Jorda, 2005) to trace out the dynamics of economic growth following reform (relative to the counterfactual of no reform)⁴. Our data cover many sectors – real and financial – and include liberalisation in product markets (cross-border trade in goods and services; deregulation of network industries such as electricity and telecommunications); factor markets (employment protection legislation); and financial markets (domestic regulations concerning interest rates, banking; securities markets; and restrictions on cross-border capital movements). While there are differences across the sectoral reform indices in terms of growth impact, it is illustrative to look at a composite reform indicator, which is the simple average of the sectoral indices.

Our specification controls for: country and time fixed effects (to measure cross-country differences in average growth and global factors like technology, energy prices or the business cycle); lags of the dependent variable (growth) and the main independent variable (liberalisation, or the change in the reform index); and country-specific time trends to account *inter alia* for the evolution in regulation in different countries pre-reform. In robustness checks, we expand the set of controls to include: expected (as of period $t-1$) economic growth to capture the possibility that reforms may be implemented in response to weak expected growth); contemporaneous and lagged fiscal deficits and inflation (to account for the possibility that reforms may be implemented as part of macroeconomic stabilisation packages); leads of the reform variable (to account for the possibility that reforms may be adopted in sequence or reversed during the horizon of the impulse response functions).

Figure 1 shows the dynamic evolution of GDP (the impulse response estimated directly from the LP model) following a reform. The figure shows that a major reform (defined as a two-standard deviation increase in the reform index) is associated with an increase in output of about 1 percent after five years, an impact that is statistically and economically significant. Note, however, that the growth dividend is very small at first, and builds slowly over time. Adding additional controls – including the budget deficit, inflation, expected future growth and additional lags of the reform indicator – yields results that are similar to, and not statistically different from, those shown in Figure 1 for the baseline case.

⁴ In Ostry *et al* (2009), the dependent variable is *per-capita* growth, whereas in Alesina *et al* (2020), it is growth. As explained in Ostry *et al* (2009), the empirical specification is in line with the neoclassical growth model, according to which a change in fundamentals – in this case reform – leads to a pickup in the growth rate in the transition from one steady state to another, and a higher steady-state *per-capita* income level.

Figure 1: Output effect of reform (%)



Source: Bruegel based on Alesina *et al* (2020). Note: The dynamic evolution of GDP and associated 90 percent confidence bands is plotted with reference to reform time on the horizontal axis. Year zero denotes the reform year.

The growth dividend following reform portrayed in Figure 1 holds for average business-cycle conditions. In a richer model that allows for heterogeneous effects depending on the strength of overall business-cycle conditions, the payoff from reform is smaller when business-cycle conditions are weak (recession) and larger when business-cycle conditions are strong (boom). This may reflect the difficulty of reallocating labour across the economy when business-cycle conditions are unfavourable (and the greater ease of doing so during good times).

3 Electoral impact of reforms: timing is critical

What about the electoral effect of reforms? The political economy literature underscores the possibility of political hesitancy because diffuse and delayed gains may not be enough in voters' minds to offset concentrated and immediate losses from reform. This is all the more intriguing given the results in the previous section that indicate a slowly maturing growth dividend from liberalisation.

This leads us to ask whether the electoral consequences of reform depend on *when* the reform is implemented in the electoral calendar. If reforms are implemented close to an election, there is the potential for short-term distributional costs to loom very large relative to the aggregate gains. But if reforms are implemented early in the electoral calendar, the aggregate gains may be substantial and more visible than the distributional losses from the past.

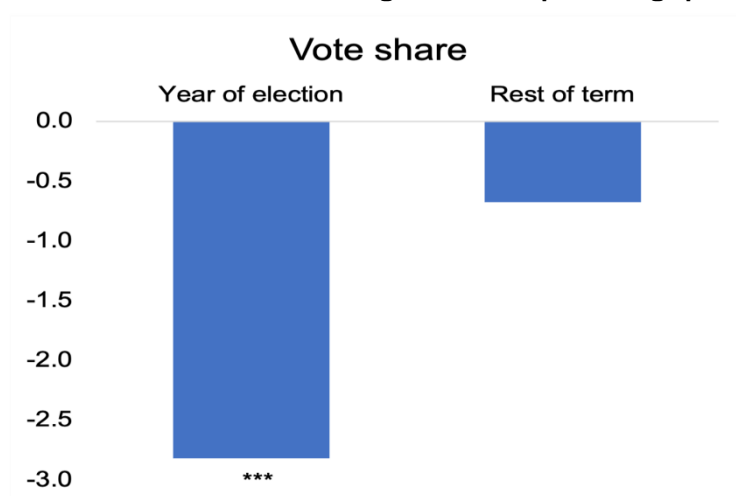
In the electoral model, the dependent variable is the change in vote share of the incumbent's party or coalition. The main explanatory variables are: (i) reform in the election year; and (ii) reform in the rest of the electoral term⁵. Other controls include binary indicators to take account of characteristics of the electoral system (motivated by the relevant political science literature), as well as GDP growth to

⁵ Electoral year reform is defined as the change in the structural reform indicator in an election year; when elections take place in the first three months of the year, the reform is coded as belonging to the previous year. Reform in the rest of the term is defined as the change in the index between the beginning of the incumbent's terms and the year prior to the election (divided by the number of years remaining in the term, to make the two measures comparable).

address potential endogeneity from the correlation between the timing of reform and the business cycle. The incumbent's vote share in the previous election is also included as a proxy for the government's popularity at the start of its term. The model is estimated using OLS.

Election-year reforms are associated with a statistically-significant decrease in the vote share of nearly 3 percentage points for a two-standard deviation reform, whereas the impact of reform implemented at other points in the electoral term do not exert a statistically significant impact on vote shares (Figure 2). Timing along the political calendar seems to be of the essence in predicting electoral effects.

Figure 2: Change in incumbent vote share following reforms (in percentage points)



Source: Bruegel based on Alesina *et al* (2020). Note: The figure shows the impact of election-year reforms and rest-of-the-term reforms on the vote share. *** indicates significance at the 1 percent level.

There is a marked difference, however, in the electoral penalty engendered by election-year reforms depending on overall business-cycle conditions. The negative electoral impact of election-year reforms is concentrated *solely among reforms enacted in election years with weak economic activity*⁶. In fact, the electoral penalty in recessionary election years is almost twice as large as the average result for the sample as a whole portrayed in Figure 2. The model, it bears noting, already includes as a separate control the level of economic growth (both in the election year and rest of the term).

4 Interpreting the combined results on economic and electoral effects

Our results are consistent with the view that voters are short-sighted and may not appreciate how long it takes for reform to generate an economic payoff. They are also consistent with theoretical models under which reforms generate concentrated losses that cause voters to retaliate against a reforming

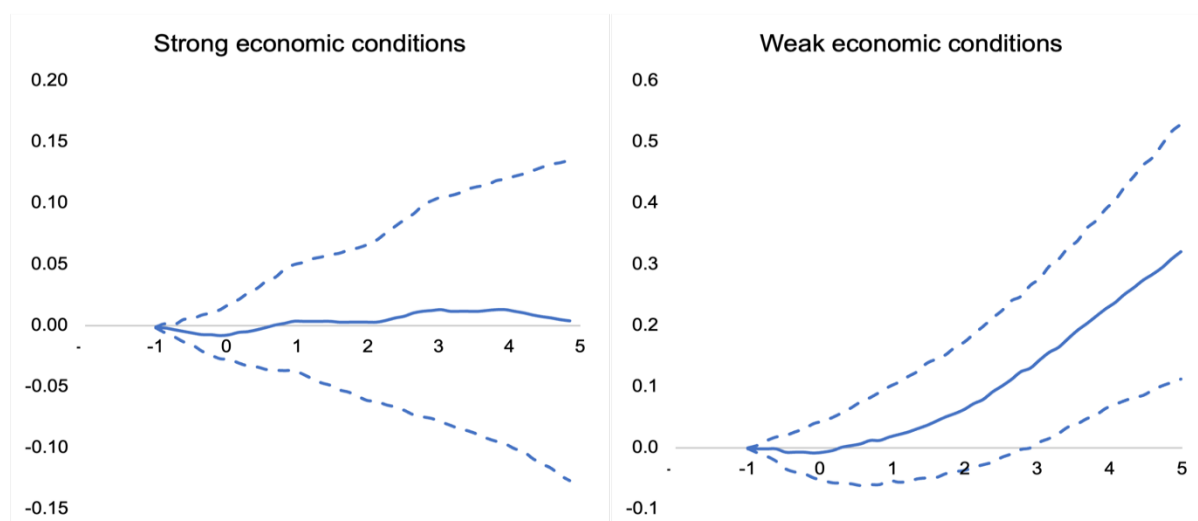
⁶ The impact on incumbent vote share of election-year reforms when economic conditions are strong is not statistically different from zero.

government facing a looming election. Such retaliation may be a rational response in a repeated game between elected officials and different economic constituencies.

That voters punish reformist governments especially when reform takes place in weak business-cycle conditions resonates with the view that voters are unable to distinguish accurately between the effects of the business cycle and those of the reform. Voters attribute the state of the economy to recent reforms without allowing for delays in the transmission of reforms to the economy. Because of a signal extraction problem, voters struggle to determine how much of a downturn is due to the policymaker's actions versus other factors. Undertaking reforms in circumstances when there is a sizable constituency that benefitted from the previous regulatory regime is perilous for reformist politicians.

Finally, the electoral results that diverge depending on the strength of economic conditions overall may relate to the more pronounced dis-equalising effect of reforms in tough economic times, when workers made redundant as a result of reforms find it that much harder to find new employment opportunities. Figure 3 illustrates the different inequality effects of reform depending on business cycle conditions⁷.

Figure 3: Distributional effect of reform (in GINI points), as a function of economic conditions



Source: Bruegel. Note: Inequality effects are estimated from a local projections model with the GINI as the dependent variable. Reform time is plotted on the horizontal axis, with $t = 0$ denoting the year of reform.

⁷ There is a continuum of possible interpretations for the electoral effects, and those discussed briefly here are not exhaustive. Reforms may be perceived as unfair and those perceptions might drive electoral outcomes. The electorate might be surprised by growth outcomes and if the surprise is negative, their disappointment might trigger retaliation against the government (one might test such a possibility by including a term in growth surprises in the electoral model – growth expectations are already included as a robustness check and do not alter the results). There may also be recency bias that disappears when the concentrated losses experienced immediately following reform is many years in the rear-view mirror.

5 Endogeneity issues

A concern with the OLS results is that governments can sometimes be strategic about the timing of reforms. Most obviously, they may choose to take advantage of high initial popularity to push through unpopular reforms, and indeed in our data, indicators of popular support are positively correlated with reform. And, as one might therefore expect, adding popular support as an additional control to the baseline model amplifies the basic finding that election-year reforms are electorally costly – increasing the estimated electoral penalty substantially.

A thornier aspect of endogeneity relates to the timing of elections, which in some countries can be at the discretion of the government. In our sample, exogenous elections (where the head of government does not have the power to dissolve parliament or call elections) make up about 40 percent of the data. In other cases, reforms may be externally mandated and thus not solely the choice of the government. Examples might be situations where the country enters into an IMF-supported programme. Finally, the literature on economic reform has made recourse to an external instrumental variable (IV) based on the change in democracy scores in trading partners (Giuliano *et al*, 2013; Acemoglu *et al*, 2019).

We run a variety of different models that stand some chance of better identifying the causal impact of reform on electoral outcomes. The pattern of the results is clear. OLS tends to show much smaller electoral penalties from reform than those estimated when we look at exogenous elections, elections under an IMF programme, or use the IV for reform. Our findings confirm that politicians may decide not to implement reforms because they are aware of (and fear) the possible political costs.

6 Types of reform

So far, our analysis has focused on the impact of an aggregate reform indicator. What about the individual reform measures that make up the average index? An interesting part of the answer to this question is the difference between real-sector reforms (those involving trade, product and labour markets) and financial-sector reforms (those involving domestic finance, capital flows and financial aspects of the current account). Here, the results show that, while the effect of financial reforms on the vote share is large and statistically significant, the effect of real-sector reforms is not statistically different from zero. Similar results are obtained when estimating the impact of each reform separately.

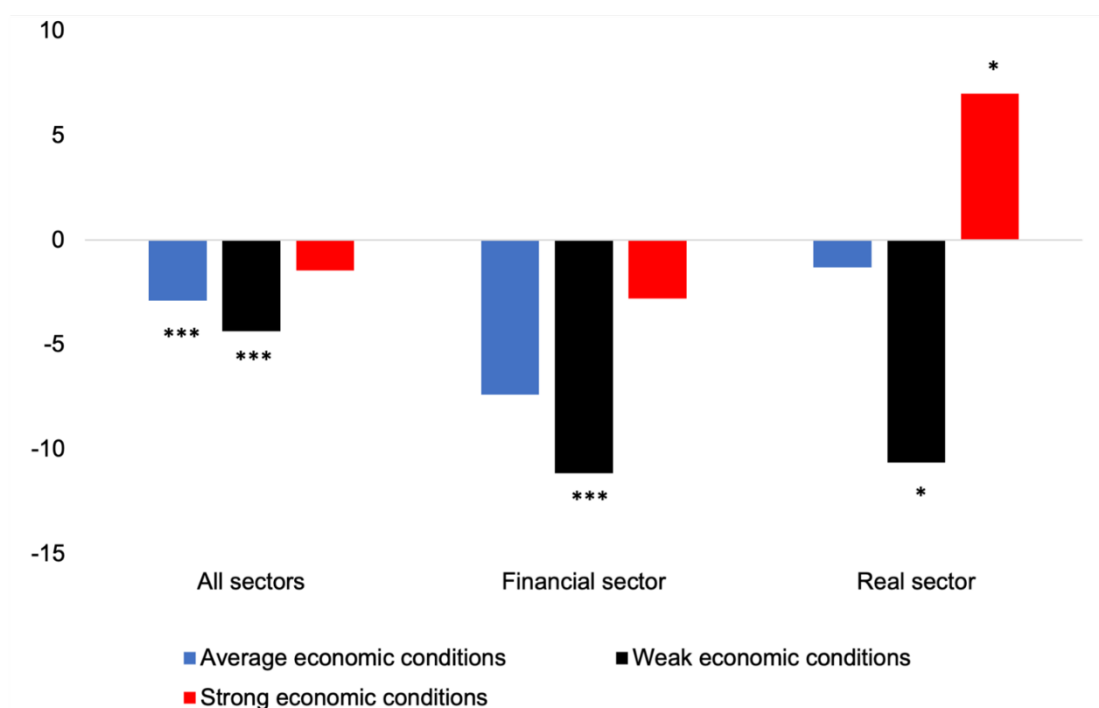
The pattern of electoral effects portrayed in Figure 4 is consistent with the evidence that financial-sector reforms may be especially prone to generating increased income inequality (de Haan and Sturm, 2017; Furceri *et al*, 2019; Furceri and Ostry, 2019; Ostry *et al*, 2019), and so generate an equity-efficiency tradeoff (Ostry *et al*, 2021), increasing both growth and inequality⁸.

⁸ The possibility that some reforms generate a growth-equity trade off while other types avoid the trade-off is not taken up in Alesina *et al* (2020), but it is taken up explicitly in Ostry *et al* (2021), with findings in line with the narrative posited here. With respect to external financial liberalisation specifically, the issue of a growth-equity trade off is taken up in detail in Furceri *et al* (2019), again with results that align with the narrative provided here. On whether external financial

Echoing the results presented earlier about liberalisations engendering higher inequality when the cyclical position of the economy is weak overall, we find that financial reforms are especially likely to cause a decline in vote share when they are enacted during periods of weak economic activity. The tie-in to rising inequality as a contributing factor is plausible. Indeed, the electoral penalty from reforms seems heavily concentrated among financial reforms implemented during bad economic times⁹.

There is also evidence that real-sector reforms enacted when the economy is doing well may boost the incumbent's vote share. With a substantial growth dividend and smaller distributional effects, real-sector reforms enacted in favourable cyclical conditions seem electorally benign to positive.

Figure 4: The effect of reform on vote shares: reform type and cyclical economic conditions



Source: Bruegel. Note: The bars show the impact of a major (two-standard-deviation) change in the reform indicator on the incumbent vote share. *** denotes statistical significance at the 1 percent level and * denotes statistical significance at the 10 percent level.

liberalisation generates a voter backlash because it increases the risk of a crisis, the findings in Furceri *et al* (2019) show that in countries that experienced a crisis following external financial opening, the growth dividend was smaller and the inequality increase was larger; whereas when countries avoided crisis, the growth-equity trade off was far more favourable.

⁹ One possibility to explain why financial reforms generate an electoral backlash close to elections but not earlier in the electoral term is that governments take measures to reverse the increase in inequality engendered by financial reforms. The evidence presented in Ostry *et al* (2019) is not supportive of this hypothesis. Indeed, the finding there is that the extent of redistributive policies actually diminishes following openings to external finance, even though the increase in inequality might have justified an increase in redistribution.

7 Takeaways

The electoral impact of reforms depends on their timing in relation to the electoral and business cycles. Reforms are politically costly when enacted close to elections, but are typically benign when enacted earlier in the term. This finding is consistent with evidence that the economic dividend from reforms accrues slowly over time, and an electorate that does not appreciate the lag between reform implementation and the resulting economic benefit. A further rationalisation is that delayed economic benefits from liberalisation are paired with immediate and concentrated losses to certain groups which, notwithstanding being in a minority, may be vocal opponents of reforms.

Apart from timing along the electoral cycle, overall business-cycle conditions are an important determinant of the political fallout from reform. Liberalisations implemented during recessionary conditions are far more likely to be penalised electorally than reforms implemented when cyclical conditions are robust. This finding is consistent with a signal-extraction problem, according to which the electorate cannot easily discriminate between the various causes of a recession, and may misattribute it to the implementation of reform when in reality other factors were responsible.

The political economy of reform is treacherous. Facile economic advice to politicians to simply get on with it is naïve. Important takeaways from our research are to reform early in the electoral term and be opportunistic by taking advantage of favourable business-cycle conditions. And be especially careful of reforms that generate large distributional effects alongside delayed and small growth dividends. The political economy of reform is all the more complex, of course, because politicians can rarely, if ever, optimally choose the timing of reforms.

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